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CURRENT PRACTICES IN REAL ESTATE SYNDICATION

SYNDICATION is legally defined as "a combination of persons or firms united for the purpose of enterprises too large for individuals to undertake . . ."* Commonly, a syndicate is a joint venture of two or more people attempting to utilize the principles of spreading risk and combining assets in order to earn a profit. Although this is by no means a new concept, its current application in the real estate field commands investigation and analysis.

It is the purpose of this article to point out some of the recent trends and future possibilities of syndicating real estate investments. Also, the necessity for an accurate and projected appraisal must be stressed.

In the last decade more and more real estate syndicates have been formed to purchase all types of income-producing properties. Large apartment buildings, industrial sites, shopping centers, offices, and subdivision tracts serve to illustrate a few examples of recent purchases by both large and small syndicate groups. The reasons for entering into combined purchases are as varied as the types of properties acquired. Syndicates attract investors whose desires range from establishing family trusts to diversifying investments to speculation.

In the past, so far as real estate investments were concerned, the pooling of assets was largely limited to groups of individuals having the same investment aims and in the majority of instances enjoying close personal relationships. Commonly, a limited partnership was created among groups of relatives or business associates in order to secure enough funds to accumulate the necessary equity to finance the real estate desired. Today, this is still the basis for the greatest number of real estate syndicate purchases. As the influence of specialization spreads to the real estate field, we find many joint operations being based on the skill and confidence of an organizer or syndicator, rather than on a close personal relationship among the investors. Still more dynamic and the primary theme of this article are the large syndicating ventures that offer shares in individual promotions to the public. Previously, the majority of small investors limited their purchases to individual stocks or bonds. With the advent of mutual funds the low-price purchaser was able to obtain an indirect share in corporations that were formerly beyond his invest-

*Henry Campbell Black, Black's Law Dictionary, St. Paul, Minn., West Publishing Company, 1951, page 1620.

ment capacity. Like the mutual fund, the large-scale real estate syndicate opens investment opportunities which enable the small investor to share in the purchase of a large real estate enterprise. Some of the pioneer examples of this type of syndicate are successfully and actively in operation in New York and California.

Our research reveals that only the relationships among the investors seem to allow for any semblance of classification when referring to real estate syndicates. These relationships take two forms, which we prefer to term homogeneous groups and heterogeneous groups. The homogeneous operations take in the smaller personal, family, or business-type relationships that have been performing syndicate operations for years. By heterogeneous, we refer to the large-scale operations which allow widespread ownership among unrelated individuals.

The various organizational structures currently used in real estate syndicate formation take the form of partnerships, trusts, or corporations. Both classifications of syndicates may utilize these business patterns. Because of legal and geographical differences, many other terms may be found to describe syndicate organizations. In our study, the aforementioned business forms seem to encompass the majority of real estate syndicate operations.

Although the heterogeneous-type operation is primarily concerned with large income-producing properties, it must be remembered that the size of the investment is limited only to the capitalization capacity of the individuals forming the syndicate.

In any joint venture involving the purchase of real estate, careful research must be applied in an effort to determine which business pattern is best suited to the particular syndicating group concerned.

Where legally applicable, realty may be owned and transferred in the name of a partnership. The major reason for choosing to operate as a partnership is the desire to avoid the tax attributable to a corporate setup. No tax is placed on the partnership by the Federal Government because the individual members must state their proportional incomes on their personal tax forms. A partnership return (form 1065) must be filed whether a book profit is earned or not. The major disadvantage of taking title by use of a partnership is that the obligations of personal liability are not discharged. Joint ventures, limited partnership, tenancy in common, family partnership, etc., are examples of current terms applied to derivations of the partnership organization. Expert legal counsel is naturally advised in selecting the most advantageous arrangement. Also, a partnership may, under certain conditions, elect to be taxed as a corporation. This feature will prove useful if increased expenditures become necessary in order to purchase larger future investments.

In some instances, syndicators function as trustees in the operations of their enterprises. Assumption of title through a trust arrangement is frequently used in an effort to gain some of the advantages of a corporation while avoiding the disadvantage of the corporate "double tax." In a trust situation, the

title is taken and held by an appointed trustee. In most cases involving realty, the trustee is given a broad scope of management powers. This feature, coupled with a carefully drawn trust agreement, will enable the organization to continue for many years even though some transfers of ownership interests occur. The main disadvantage of a trust that endeavors to avoid being taxed as a corporation lies in the fact that most trust operations tread the thin line that separates them from being designated "associations." If a trust is deemed an association, it will then be taxed in a manner similar to a corporation.

The corporate form of taking title is best suited to the heterogeneous type of syndicate, but may be applied to the homogeneous operations as well.

The title is held in the name of the corporation and the members of the syndicate are issued stocks and debentures. In our opinion, the corporate form offers many advantages and protections for small investors. These attributes take the form of the legal safeguards afforded by corporate structures and the benefits derived from the utilization of specialized management. Limited liability; Government regulation; facility in the execution of leases, mortgages, and deeds; and ease of transfer of securities illustrate some of the advantages of incorporating a syndicate.

The corporation is subject to taxation on the net income of the real estate. These earnings are in turn disbursed to the shareholders where they are again taxed as personal income. This "double tax" is the major disadvantage of the corporate business pattern.* In order to alleviate some of the consequences of the "double tax," one practice has been to issue combined units of stock and debentures. The debentures should contain a firm repayment clause which states an annual principal payment plus a set interest rate. Also a high ratio of debentures to stock must be maintained. If the previous two conditions are adhered to, then the annual payments on the debentures will be a nontaxable return of capital, except for the prescribed interest payments.

Currently, one of the basic advertising aims of most large-scale syndicators is to demonstrate the effects of depreciation as a tax advantage. Depreciation is charged against the income earned by the real estate for tax purposes. As this charge does not represent a cash expenditure, it is possible for the realty to show no taxable income or sometimes a loss. At the same time, it is feasible to accumulate a surplus of cash that can be distributed to the investors in the form of a return of capital. At present, if such a distribution is not paid from earnings or profits, it is not taxed as dividend income. In order to take the fullest advantage of such depreciation possibilities, it has been the practice to syndicate older properties on which the Internal Revenue Service will allow a high depreciation rate over the remaining life. It must be borne in mind that the depreciation charge will run out eventually and the distributions to the shareholders will be taxed at the current income rate.

It is our opinion that the current interest in real estate syndication has been

*Pseudo-corporations meeting certain requirements may elect to avoid the "double tax." One of these requirements is that the corporation be limited to 10 stockholders.

fostered by the inflated prices that large income-producing properties command. This has greatly curbed the ability of the large investors to operate alone or in small groups. This inflationary trend, combined with the need for greater capital outlays, has opened the real estate field to the mass of small investors through the operations of large-scale, professionally managed real estate syndicates. As in all rapidly developing fields of enterprise, the borderline or fringe operator must be watched for and discouraged.

The cornerstone in any legitimate syndicate endeavor is the property being offered as security for the shareholders' investment. In order to secure the correct parcel, the promoters should have a reliable and accurate appraisal to substantiate their expectations and claims concerning the subject property. Before any syndicate solicits public investments, it should be prepared to offer certified appraisal opinions upon request. A complete appraisal for a syndicate operation must include a projected schedule of income, operating expenses, and operating profits for a 5- to 10-year period.

Naturally, the projection is only an estimate, but the thoroughness with which it is developed depends upon the ability and tenacity of the appraiser. Such a schedule would show the gross rentals for the current year and the projected gross rentals for each succeeding year. An adequate vacancy allowance must be deducted from each of these yearly gross rental figures. Deductions will be made for operating expenses, which include salaries, taxes, insurance, utilities, maintenance, supplies, management (usually 5% of effective gross income), etc. Added to these expenses estimates of repairs should be itemized. Totaling the operating expenses and the repairs would give us a figure that is deducted from the rental income after vacancy allowance. The result is the operating profit for each individual year of the projected appraisal before interest and depreciation charges. Consideration should also be given to an estimate of depreciation for a projected period of 5 to 10 years and its effects on income tax calculations. Finally a cash projection statement is determined which endeavors to illustrate the year by year effect of principal and interest payments along with disbursements to shareholders and possible cash reserve cumulations.

Although appraisals of the type mentioned require time, experience, and expenses, it is our opinion that as the competition among syndicates increases and as the public becomes more discriminate, a thorough projected appraisal will be demanded by the shareholders as well as the financing institutions involved.

The future appeal of real estate syndications to the small investor seems very encouraging. The thought of owning a part of a tangible structure is stimulating to the average investor. Appraisers, brokers, lawyers, property managers, and lending institutions will benefit from the new and diverse possibilities of collective ownership in real estate through syndication.

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